

Message Text

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SUBJECT: COMMISSION REPORTS ON MEMBER STATE ECONOMIC POLICIES
AND PROPOSALS FOR ADJUSTMENT TO GUIDELINES FOR 1977

REF: (A) 76 EC BRUSSELS 7367, (B) 76 EC BRUSSELS 10774,
(C) 76 EC BRUSSELS 11481, (D) EC BRUSSELS 2501

1. SUMMARY: IN TWO DOCUMENTS PRESENTED TO THE LATEST EC
FINANCE COUNCIL, THE COMMISSION PRESENTS, ON BALANCE, AN
UNFAVORABLE ASSESSMENT OF EFFORTS TO IMPROVE ECONOMIC POLICY
CONVERGENCE IN 1976, AND A GLOOMY OUTLOOK FOR THE REMAINDER OF
1977. MEMBER STATES GET MIXED REVIEWS ON THEIR ADHERENCE TO
1976 ECONOMIC POLICY GUIDELINES; SUCCESS IN REDUCING DISPARATE
ECONOMIC TRENDS IS RATED AS POOR. REAL GROWTH IN 1977 IS
LIKELY TO BE UNSATISFACTORY AT 3 1/2 PERCENT, WITH A WORSENING
OF LABOR MARKET CONDITIONS. INFLATION TRENDS WILL CONTINUE TO
BE UNSATISFACTORY AND HIGHLY DIVERGENT, ALTHOUGH SOME IMPROVE-
MENT MAY BE EXPECTED IN THE SECOND HALF. POLICY GUIDELINES
REMAIN FUNDAMENTALLY THE SAME, BUT WITH ADDITIONAL EFFORTS
NEEDED TO ENSURE ADEQUATE REVIVAL IN GERMANY AND THE
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NETHERLANDS, AND REDUCE INFLATION IN ITALY, IRELAND,
AND THE UNITED KINGDOM. END SUMMARY

2. THE EC COMMISSION HAS REPORTED TO THE COUNCIL ON
ECONOMIC POLICIES PURSUED BY MEMBER STATES IN 1976 IN
RELATIONSHIP TO THE GUIDELINES BY THE COUNCIL (REF A).
IN A SEPARATE REPORT, THE COMMISSION HAS ALSO REVIEWED

THE ECONOMIC OUTLOOK AND PROPOSED ADJUSTMENTS TO THE ECONOMIC POLICY GUIDELINES FOR 1977, WHICH WERE ORIGINALLY PROPOSED IN OCTOBER (REF B) AND ADOPTED BY THE COUNCIL IN NOVEMBER 1976 (REF C). AS REQUIRED BY THE COUNCIL DECISION ON CONVERGENCE OF ECONOMIC POLICIES OF FEBRUARY 18, 1974 THESE REPORTS WERE CONSIDERED AND THE NEW GUIDELINES ADOPTED AT THE MARCH 14 FINANCE COUNCIL (REF D). BOTH REPORTS HAVE BEEN POUCHED TO THE DEPARTMENT (EUR/RPE - GELBARD).

3. POLICY IN 1976. THE REPORT ON POLICY IN 1976 NOTES SOME GENERAL IMPROVEMENT IN ADHERENCE TO BUDGETARY POLICY GUIDELINES (COMPARED TO PREVIOUS YEAR) ALTHOUGH EXPENDITURE SUBSTANTIALLY OVERRAN GUIDELINES IN BOTH FRANCE AND ITALY. IN ITALY, THE TIGHTENING OF TAXATION RESULTED IN A LOWER TREASURY DEFICIT THAN EXPECTED, WHILE IN THE U.K. A HIGHER RATE OF INFLATION THAN EXPECTED STIMULATED RECEIPTS, AND PROBABLY KEPT THE PUBLIC SECTOR BORROWING REQUIREMENT SLIGHTLY UNDER COMMUNITY GUIDELINES.

4. ALTHOUGH GUIDELINES FOR MONETARY POLICY WERE GENERALLY DESIGNED TO SUPPORT THE ECONOMIC RECOVERY, POLICY WAS SHIFTED IN A RESTRICTIVE DIRECTION DURING THE YEAR TO DEFEND EXCHANGE RATES AND COMBAT INFLATION. THE REPORT NEVERTHELESS NOTES THAT NORMS FOR GROWTH OF MONETARY AGGREGATES WERE EXCEEDED IN GERMANY AND ITALY, BUT IN THE FORMER CASE THIS WAS "IN THE DIRECTION REQUIRED BY THE CONJUNCTURAL SITUATION".

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5. THE COMMISSION REVIEWS THE PROGRESS OF PRICES AND INCOMES POLICIES IN 1976, AND NOTES A SMALL DECELERATION IN THE GROWTH OF NOMINAL COMPENSATION PER EMPLOYEE (15.9 TO 13.2 PERCENT) TOGETHER WITH A SLIGHT REDUCTION IN DISPARITIES AMONG MEMBER STATES. WITH THE UPTURN IN PRODUCTION, THE RISE IN UNIT LABOR COSTS SLOWED DOWN SHARPLY (17.2 TO 8.1 PERCENT), BUT THE PROGRESS MADE IN CONTROLLING COSTS STILL VARIED SO MUCH THAT NEW DIVERGENCES APPEARED IN INFLATION RATES AND EXCHANGE RATE MOVEMENTS.

6. CHANGES IN EXCHANGE RATES ARE BLAMED ON PERSISTENT DIFFERENCES IN COST AND PRICE MOVEMENTS, AND LACK OF COORDINATION OF ECONOMIC POLICY. THE MARKED DEPRECIATION OF THE LIRA AND STERLING IS ATTRIBUTED TO RELATIVELY RAPID RATES OF INFLATION; THE COMMISSION THEN EMBRACES THE "VICIOUS CIRCLE" THESIS BY ADDING: "THIS DEPRECIATION THEN BECAME ITSELF AN INDEPENDENT (SIC) SOURCE OF INFLATION." THE COMMISSION GOES ON TO SAY THAT THESE 1976 EXCHANGE RATE CHANGES, PARTICULARLY FOR THE LIRA,

HAVE OVER-COMPENSATED FOR THE DIFFERENCES IN PRICE AND COST CHANGES. (COMMENT: AS WE POINTED OUT TO THE COMMISSION, TAKING 1975 DEVELOPMENTS INTO ACCOUNT WOULD ALTER THIS CONCLUSION. A COMMISSION OFFICIAL CONCEDED THAT THE CHOICE OF THE BASE YEAR WOULD MAKE A CONSIDERABLE DIFFERENCE.)

7. IN ITS REVIEW OF MEMBER STATE COMPLIANCE WITH REQUIRED CONSULTATION PROCEDURES, THE COMMISSION NOTES THAT PRIOR CONSULTATION REQUIREMENTS WERE NOT FOLLOWED IN SEVERAL IMPORTANT MEMBER STATE DECISIONS ON EXCHANGE RATE MATTERS. FINALLY, CITING DIVERGENT TRENDS IN GROWTH, INFLATION AND THE BALANCE OF PAYMENTS, THE COMMISSION CONCLUDES THAT, DESPITE SOME EFFORT, "1976 DID NOT SHOW ANY PARTICULARLY MARKED PROGRESS" IN ACHIEVING CONVERGENCE IN THE ECONOMIES OF MEMBER STATES.

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8. OUTLOOK AND ADJUSTMENTS TO 1977 ECONOMIC POLICY GUIDELINES. AS NOTED REF D, THE COMMUNITY'S ASSESSMENT OF THE OUTLOOK FOR 1977 IN THIS DOCUMENT IS MUCH MORE GLOOMY THAN IN THE ANNUAL REPORT, REFLECTING THE PRIVATE VIEWS THAT COMMISSION ANALYSTS HAVE HELD FOR SOME TIME (REF B). REAL GROWTH (GDP) IN THE COMMUNITY AS A WHOLE WILL PROBABLY BE AN UNSATISFACTORY 3 1/2 PERCENT, LARGELY AS A RESULT OF THE DEPRESSED INVESTMENT CLIMATE: (THE FORECAST EARLIER THIS YEAR WAS AROUND 3 PERCENT) LABOR MARKET CONDITIONS WILL PROBABLY WORSEN SOMEWHAT. THE COMMUNITY AVERAGE UNEMPLOYMENT RATE OF 4 1/2 PERCENT IN 1976 IS INTERNALLY FORECAST TO RISE TO ABOUT 4 3/4 PERCENT IN 1977.) THE RATE OF INFLATION WILL SLOW ONLY SLIGHTLY IN 1977, AND WIDE DIVERGENCES WILL REMAIN, RANGING FROM 20 PERCENT FOR ITALY TO 4 PERCENT FOR GERMANY (CONSUMER PRICES, YEAR ON YEAR); HOWEVER, SOME IMPROVEMENT IS EXPECTED WITHIN THE YEAR.

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9. THE COMMISSION NOTES THE MEASURES TAKEN IN THE UNITED STATES AND JAPAN TO STIMULATE GROWTH, BUT COMMENTS THAT "THESE MEASURES WILL HAVE NEITHER A RAPID NOR ANY VERY SUBSTANTIAL DIRECT IMPACT ON THE COUNTRIES OF THE COMMUNITY..." (THE COMMISSION IS ASSUMING 1976 U.S. REAL GROWTH OF 5 PERCENT, JAPAN 6 PERCENT; CANADA 4 PERCENT; OTHER NON-EEC DEVELOPED COUNTRIES 3 PERCENT; REAL VOLUME OF NON-EEC IMPORTS 7 1/2 PERCENT.) REFLECTING SLOWER INTERNAL GROWTH THAN ABROAD, THE EC CURRENT ACCOUNT WILL MOVE INTO NEAR BALANCE FROM THE 1976 DEFICIT OF \$9 1/2 BILLION, WITH MOST OF THE IMPROVEMENT CENTERED IN THE DEFICIT COUNTRIES.

10. THE FUNDAMENTAL GUIDELINES FOR A DIFFERENTIATED STRATEGY FOR ECONOMIC POLICY REMAINS THE SAME, WITH ADDITIONAL EFFORTS NEEDED (1) TO ENSURE SATISFACTORY GROWTH IN GERMANY AND THE NETHERLANDS (5 AND 4 PERCENT RESPECTIVELY) AND (2) TO BREAK THE SEQUENCE OF CURRENCY DEPRECIATION AND PRICE INCREASES IN DEFICIT COUNTRIES THROUGH POLICIES "AS RESTRICTIVE AS POSSIBLE." EMPHASIS IS PLACED ON THE NEED TO SUPPLEMENT STANDARD LIMITED OFFICIAL USE

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MACROECONOMIC POLICIES WITH INCOMES POLICIES, AGREED TO BY THE "SOCIAL PARTNERS", SPECIFIC EMPLOYMENT POLICIES, AND INVESTMENT DIRECTED AT STRUCTURAL PROBLEMS. BUDGETARY POLICIES SHOULD IN GENERAL BE RESTRICTIVE, BUT DIFFERENTIATED AMONG COUNTRIES. MEMBER STATES SHOULD "JOINTLY ESTABLISH A COHERENT FRAMEWORK FOR GROWTH OF THEIR PRINCIPAL MONETARY AGGREGATES."

1. HIGHLIGHTS OF THE 1977 OUTLOOK AND POLICY GUIDELINES FOR INDIVIDUAL COUNTRIES:
GERMANY
PROSPECTS LOOK SOMEWHAT BETTER THAN TWO MONTHS AGO. THE

COMMISSION ADVANCES 5 PERCENT REAL GROWTH (GDP) AS A GOAL, BUT DOES NOT SAY IT WILL BE ATTAINED ON PRESENT POLICIES. (INTERNALLY, THE COMMISSION IS FORECASTING 4 1/2 PERCENT, UP FROM 4 PERCENT TWO MONTHS AGO.) THE COMMISSION EXPECTS SOME FURTHER SLOWDOWN IN INFLATION FROM 4 1/2 TO 4 PERCENT (CONSUMER PRICES, YEAR ON YEAR), A DECLINE IN UNEMPLOYMENT TO 3.5 PERCENT (YEAR AVERAGE) ASSUMING THE 5 PERCENT GROWTH OBJECTIVE IS ATTAINED (3.7 PERCENT IF COMMISSION FORECAST IS CORRECT), AND A CURRENT ACCOUNT SURPLUS ABOUT THE SAME AS LAST YEAR: DM 8.5 BILLION. POLICIES SHOULD BE MORE EXPANSIONARY THAN IN PREVIOUS GUIDELINES, BUT AIMED ONLY AT STIMULATING INVESTMENT, NOT CONSUMPTION. SPECIFIC SUGGESTIONS BEYOND POLICIES ALREADY IN PLACE ARE LIMITED TO ACCELERATING THE IMPACT OF THE PLANNED PUBLIC WORKS PROGRAM. THERE IS ALSO A REFERENCE TO "A CASE FOR CERTAIN TAX RELIEFS TO GIVE DESIRABLE INCENTIVES TO PRIVATE INVESTMENT." WE ARE TOLD THAT THIS REFERS TO A COMMISSION IDEA FOR LIBERALIZING THE TAX TREATMENT OF DEPRECIATION ALLOWANCES. THIS IDEA REPORTEDLY HAS SOME SUPPORT WITHIN THE GERMAN GOVERNMENT FROM FRIEDRICH, BUT APEL IS OPPOSED, AND NO DECISION HAS BEEN TAKEN. THIS IS VIEWED AS A MEDIUM-TERM MEASURE, RATHER THAN ONE WHICH WOULD HAVE ANY IMPACT THIS YEAR, OR EARLY NEXT. LIMITED OFFICIAL USE

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FRANCE

THE COMMISSION EXPECTS 3 PERCENT GROWTH (WELL UNDER THE FRENCH TARGET), A MODEST EASING OF INFLATION (FROM 9.3 TO 8 1/2 PERCENT), AN INCREASE IN UNEMPLOYMENT TO 5.1 PERCENT, AND A SIGNIFICANT REDUCTION IN THE CURRENT ACCOUNT DEFICIT. (WE ARE INFORMED THAT THE COMMISSION STAFF WISHED TO SPECIFY THE CURRENT ACCOUNT DEFICIT AT ABOUT 20 BILLION FRANCS, BUT THE ORTOLI CABINET VETOED THE INCLUSION OF THE FIGURE AS TOO PESSIMISTIC FOR PUBLIC VIEW.) THE PRESENT RESTRICTIVE POLICY STANCE IS SUPPORTED, WITH A CAUTION THAT AN EASING IN INTEREST RATES NOT BE ALLOWED TO JEOPARDIZE THE STABILITY OF THE FRANC AND UNDERMINE ANTI-INFLATION EFFORTS.

UNITED KINGDOM

THE COMMISSION EXPECTS REAL GROWTH OF 1 1/2 PERCENT, NO SIGNIFICANT CHANGE IN THE UNDERLYING RATE OF INFLATION (ABOUT 15 PERCENT) UNTIL ABOUT MID-YEAR, WHEN A MARKED SLOWDOWN SHOULD OCCUR (REFLECTING POLICY TIGHTNESS AND EASING EFFECTS OF THE 1976 STERLING DEPRECIATION). UNEMPLOYMENT IS LIKELY TO RISE FROM 5.2 TO 5.9 PERCENT, AND THE CURRENT ACCOUNT DEFICIT

FOR THE YEAR SHOULD BE LESS THAN 1 BILLION POUNDS. THE COMMISSION SUPPORTS THE RESTRICTIVE POLICIES ALREADY ANNOUNCED, WARNING AGAINST ANY ATTEMPT TO REDUCE UNEMPLOYMENT BY STIMULATING CONSUMPTION. IT UNDERLINES THE NEED FOR A SATISFACTORY ARRANGEMENT FOR THE NEXT ROUND OF INCOMES POLICY BEGINNING IN AUGUST, AND SUGGESTS, AS PART OF THIS EFFORT, THAT DIRECT PERSONAL TAXATION MIGHT BE REDUCED. ALSO, THE GOVERNMENT SHOULD CONSIDER THE POSSIBILITY OF ALLOWING THE EXCHANGE-RATE TO APPRECIATE IN THE INTERESTS OF ANTI-INFLATION POLICY.

ITALY
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OWING TO THE VIGOROUS EXPANSION LATE IN 1976 REAL GROWTH IS NOW FORECAST AT NEARLY 3 PERCENT, INSTEAD OF LESS THAN 1 PERCENT AS PREVIOUSLY EXPECTED. INFLATION IS EXPECTED TO REACH 20 PERCENT, YEAR ON YEAR (OR ABOUT 16 PERCENT YEAR END TO YEAR END). (WE ARE TOLD PRIVATELY THAT THE COMMISSION URGED THE ADOPTION OF A 16 PERCENT YEAR-ON-YEAR NORMATIVE TARGET, WHICH WOULD IMPLY 10-11 PERCENT WITHIN YEAR, BUT STAMMATTI SUCCEEDED IN HAVING THIS INTERPRETED AS 16 PERCENT WITHIN YEAR - I.E., IDENTICAL TO THE COMMISSION'S FORECAST ON PRESENT POLICIES.) THE CURRENT ACCOUNT IS EXPECTED TO IMPROVE, BUT , WE ARE TOLD PRIVATELY, BY NOT NEARLY AS MUCH AS THE ITALIAN TARGET -- I.E., PROBABLY A SMALL DEFICIT, INSTEAD OF THE TARGETED SURPLUS. THE COMMISSION URGES AN INTENSIFICATION OF RESTRICTIVE POLICIES, INCLUDING TIGHTER EXPENDITURE POLICIES, TIGHTER MONETARY POLICIES (INCLUDING MAINTENANCE OF BANK LENDING CEILINGS BEYOND MARCH), REDUCTION OF THE MONETARY FINANCING OF THE DEFICIT, AND MORE EFFORTS TO REDUCE LABOR COSTS.

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NETHERLANDS

3 1/2 - 4 PERCENT REAL GROWTH, SLIGHT DECLINE IN AVERAGE UNEMPLOYMENT TO ABOUT 4.4 PERCENT, SLOWDOWN IN INFLATION FROM 9 1/2 TO 7 1/2 PERCENT (REFLECTING IN PART APPRECIATION OF GUILDER), LARGER CURRENT ACCOUNT SURPLUS (ABOUT F1 7 BILLION). DESPITE RELATIVE SUCCESS AGAINST INFLATION AND PAYMENTS SURPLUS, NO FURTHER NET STIMULUS IS RECOMMENDED, WITH ADHERENCE TO EC GUIDELINES OF F1 12 BILLION NET BORROWING REQUIREMENT. RELATIVELY LOW INTEREST RATES TO AVOID APPRECIATION WITHIN SNAKE.

BELGIUM

3 PERCENT REAL GROWTH, INFLATION RATE ABOUT UNCHANGED AT 8 PERCENT, CONTINUED SMALL CURRENT ACCOUNT SURPLUS, AVERAGE UNEMPLOYMENT UP TO ABOUT 6.6 PERCENT. THE PRESENT FISCAL POSTURE IS SUPPORTED, WHICH ALLOWS ORIGINAL EC BUDGETARY GUIDELINES TO BE COMPLIED WITH IN THE FACE OF DECLINING REVENUES, WHILE STILL GIVING LIMITED OFFICIAL USE

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SOME SUPPORT TO ACTIVITY IN THE INVESTMENT AREA.

DENMARK

2 PERCENT REAL GROWTH, 8 1/2 PERCENT INFLATION, AVERAGE UNEMPLOYMENT RISING FROM 5 TO 5.6 PERCENT, AND A SMALL REDUCTION IN THE CURRENT ACCOUNT DEFICIT (DKR 9 BILLION). POLICIES TO REMAIN GENERALLY RESTRICTIVE, ALTHOUGH SOME SUPPORT TO INVESTMENT MAY BE NECESSARY.

IRELAND

LESS THAN 1 PERCENT REAL GROWTH, SOME MODERATION IN INFLATION IN SECOND HALF (ABOUT 15 PERCENT, YEAR ON YEAR), LEVEL UNEMPLOYMENT AT 9 1/2 PERCENT. GUIDELINES REMAIN UNCHANGED.

12. COMMENT: THE COMMISSION'S FORECASTS ARE CLOSE TO THE INTERNATIONAL CONSENSUS. ONE CAN CATCH CLEAR GLIMPSES OF CERTAIN PREDICTABLE COMMISSION POLICY PERSPECTIVES: E.G., INVESTMENT ORIENTED STRATEGY WHERE SUPPORT TO ACTIVITY IS REQUIRED; STRONG RELIANCE ON INCOMES POLICIES; A TENDENCY TO PLACE EXCHANGE-RATE STABILITY IN THE INTERESTS OF ANTI-INFLATION EFFORTS AHEAD OF POSSIBLE NEEDS TO ADJUST COMPETITIVE POSITION; AND AN UNDERLYING BELIEF THAT BETTER COORDINATION OF ECONOMIC POLICY -- NOT JUST BETTER ECONOMIC POLICY -- IS A KEY FACTOR IN IMPROVING PERFORMANCE AND REDUCING CONFLICTS BETWEEN POLICY OBJECTIVES (E.G., INFLATION CONTROL VERSUS GROWTH).

13. DESPITE ITS UNHAPPINESS AT 1977'S WEEK GROWTH PROSPECTS, POLICY RECOMMENDATIONS ARE STILL, ON BALANCE, STRONGER IN SUPPORTING RESTRICTIVE POLICIES FOR INFLATIONARY/ DEFICIT COUNTRIES THAN IN URGING STIMULUS ON THE SURPLUS COUNTRIES. THIS CAUTION MAY WELL BE WARRANTED, BUT SLOW EXPANSION AND CONTINUED HIGH UNEMPLOYMENT WILL BE THE LIMITED OFFICIAL USE

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INEVITABLE RESULT IN THE SHORT-RUN. NEITHER BETTER POLICY "CONVERGENCE" NOR MORE STRUCTURAL AND INCOMES POLICIES - HOWEVER DESIRABLE OR USEFUL IN THE LONGER RUN -- WILL CHANGE THIS. IT MIGHT HAVE BEEN WELL FOR THE COMMISSION TO HAVE SAID THIS DIRECTLY. HINTON

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